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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 486

W. PALMER DIXON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (Pet. 8a–21a) is reported at 224 F. Supp. 358. The opinion of the court of appeals (Pet. 1a–7a) is not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1964. (Pet. 2.) The petition for a writ of certiorari was filed on September 11, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the excess of the face amount of a note over the amount of money for which it was issued represents interest which an accrual-basis lender must

accrue during the period that the note is held. Alternatively, the question is whether, if the "interest" is not currently accruable, the portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess is taxable as ordinary income or as capital gain.[1]

2. Whether the Commissioner was estopped to challenge the taxpayers' treatment of their gain from the sale of notes issued at a discount as capital gain because he had previously announced, and only later withdrew, his acquiescence in a prior decision involving a similar but distinguishable question.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set out in the Appendix, pp. 13–15, *infra*.

STATEMENT

Petitioners are partners in the investment firm of Carl M. Loeb, Rhoades & Company. At various times during the taxable year 1952, the partnership purchased 33 short-term, non-interest bearing notes, either directly from the obligor corporation, or through

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[1] Petitioners phrase the question as one of the treatment of the proceeds from the sale of the notes (Pet. 2). Technically, however, the deficiencies determined and upheld in this case were based upon the current accruability of the "interest" regardless of whether there was a sale in the taxable year. We have framed the question in an alternative form only to encompass the manner in which petitioners state it. In fact, we do not believe there is any dispute that, if the excess of the note over the issuing price is properly to be treated as "interest," the proper method of accounting for it in this case was by accrual, rather than by waiting to account for the proceeds of a sale or redemption of the note.

agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts varying between 2⅜% and 3¾% of the face value. Of these notes, 20 were sold during 1952 prior to maturity after being held for periods of six months or longer and 13 remained on hand unmatured (Pet. 3a, 8a).

In its information return for 1952, the partnership did not accrue interest on any of the notes and reported the gain from the sale of the 20 notes during that year as long-term capital gain. In reporting their distributive shares of the partnership income on their individual returns, petitioners treated the notes in the same manner. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest accruing over the term of the notes. Since the partnership was on the accrual basis, the interest accruing on all 33 of the notes during the period they were held by the partnership was determined to be includible in partnership income and hence in petitioners' distributive shares.[2] Petitioners paid the resulting deficiencies ($369,329) and in due course brought this suit for refund (Pet. 3a, 8a–9a). Both the district court (Pet. 8a–21a) and the court of appeals (Pet. 1a–7a) upheld the Commissioner's determination and denied the refunds.

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[2] As the court of appeals noted, "no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale" (Pet. 4a).

ARGUMENT

In holding that original-issue discount must be accounted for as "interest," the decision below, although clearly right and supported by the great weight of authority, is in direct conflict with the decisions of the Sixth Circuit. Accordingly, we acquiesce in the granting of certiorari to resolve that question. On the second question presented (estoppel of the Commissioner by his prior acquiescence in another case), the decision is not only correct but there is no conflict of decisions or any other reason for review by this Court. Certiorari, if granted, should therefore be limited to the first question presented.

I

1. In its treatment of original-issue discount, the decision below is correct. There is no dispute that the result would be proper if the notes had in terms provided for interest.[3] The only question is whether there is a difference for tax purposes between these two transactions: (1) *A* gives *B* $100 for *B*'s promise to pay $100 plus 6% interest (*i.e.*, $106) a year hence; and (2) *A* gives *B* $100 for *B*'s promise to pay $106 a year hence. The only discernible difference between the transactions is that in the first the additional $6 to be paid is labeled "interest", while in the second the additional $6 to be paid is not given a name.

[3] As to accruability of the "interest," see note 2, *supra*. As to the treatment of accrued "interest" on the sale or redemption of a note, see *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6).

That difference, in turn, is wholly immaterial, for, as this Court has repeatedly emphasized, tax consequences turn upon the economic substance of transactions, not the labels used by the parties. *E.g., Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260, 266–267. Interest is merely "compensation for the use or forebearance of money" (*Deputy* v. *DuPont,* 308 U.S. 488, 498); and in both transactions the additional $6 to be paid is neither more nor less than that.

That "original-issue discount" is but another name for interest is equally established by authority. First, by the decision of this Court holding that the issuer may deduct the excess of the redemption price over the issuing price as interest. *Helvering* v. *Union Pacific Co.,* 293 U.S. 282. Second, by the decisions of the First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court holding that the holder of the note realizes ordinary interest income upon the sale or redemption of the note to the extent that the proceeds are attributable to the original-issue discount.[4]

2. As petitioners state, however, the decision below (like those of the other courts noted above) is in acknowledged conflict with the decisions of the Sixth

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[4] *Real Estate Investment Trust of America* v. *Commissioner,* 334 F. 2d 986 (C.A. 1); *Rosen* v. *United States,* 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison,* 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; *Commissioner* v. *Morgan,* 272 F. 2d 936 (C.A. 9); *Pattiz* v. *United States,* 311 F. 2d 947 (Ct. Cls.); *Schwartz* v. *Commissioner,* 40 T.C. 191; *Leavin* v. *Commissioner,* 37 T.C. 766. The *Morgan* case involved an accrual-basis taxpayer and there, as here, the court held that the taxpayer must report the original-issue discount ratably as it accrued.

Circuit holding the entire gain to be taxable only as capital gain upon either a sale or a redemption of a note issued at a discount. *Midland-Ross Corp.* v. *United States,* 214 F. Supp. 631, affirmed *per curiam,* 335 F. 2d 561 (printed at Pet. 23a–42a) (sale); *Commissioner* v. *Caulkins,* 144 F. 2d 482 (redemption). To be sure, the taxable event in this case was treated as being, not the "sale" of notes, but the "accrual" of the interest during the partnership's holding of the notes, and that circumstance helps to emphasize the ultimate irrelevance to the question of the "sale or exchange" provisions upon which the Sixth Circuit has relied. In principle, however, if "interest" in the form of original-issue discount must be accrued by an accrual-basis taxpayer, it equally follows that a cash-basis taxpayer must report as ordinary income, when paid, the portion of the proceeds of a sale of a note attributable to such accrued "interest," just as he is admittedly required to do upon a sale of a note with accrued interest labeled as such. Nor was the difference in the method of accounting decisive to the court below, for it is plain from its opinion that, if the partnership had been on the cash basis, the court would equally have held that its gain from the sale of the 20 notes was taxable as ordinary income.

Even though it does not justify the difference in results, the difference between accruability of the interest and the treatment of the proceeds from a sale might afford a sufficient distinction to make review by this Court unnecessary if it served to distinguish

all of the cases. With the sole exception of the *Morgan* case, however, the decisions of the other Circuits cited above (note 4) arose in the same context as the Sixth Circuit cases (treatment of a sale or redemption), and there is thus a square conflict even apart from the decision below. Accordingly, we do not believe that the difference in the method of accounting affords a sufficient basis on which to oppose the petition in this case. Indeed, if the basic question is to be considered at all by this Court—as seems unavoidable—it seems highly desirable that it be presented in the context of accrual accounting as well as in the context of the treatment of sale proceeds.

We are simultaneously filing a petition for certiorari in the *Midland-Ross* case decided by the Sixth Circuit, in acknowledged conflict with the decision below, on July 29, 1964, *supra*. That case involves notes that were substantially identical to those in this case, even to the extent of being issued by the same financial institutions. The only difference is that the deficiencies in that case were premised upon treating the gain from the *sale* of the notes as ordinary income rather than upon requiring the "interest" to be accrued.[5] Both cases involve stipulated facts and very simple records, and in order to have the question presented in both contexts (accruability and treatment of sale proceeds), we suggest that the Court

[5] The taxpayer in the *Midland-Ross* case was in fact on the accrual basis. The only reason the deficiencies were based on the gain from the sale of the notes (rather than on accrual principles) was that all of the notes were sold in the same year in which they were acquired, making the results the same (but for negligible amounts).

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grant both petitions and set the two cases for argument together.

We are also advised that the taxpayer will file a petition for certiorari in the *Real Estate Investment Trust* case decided by the First Circuit, in conformity with the decision below and in conflict with the Sixth Circuit, on July 28, 1964, *supra*. We shall defer until our receipt of that petition any comment on whether it should also be granted or should merely be held to await the disposition of this case and the *Midland-Ross* case.

3. This case, like the others mentioned above, arises under the 1939 Code. Section 1232 of the 1954 Code expressly provides for ordinary-income treatment of the portion of the gain from the sale or redemption of notes that is attributable to original-issue discount. The question presented in this case, however, remains of continuing importance because of three significant limitations upon the scope of § 1232.

First, § 1232 applies only to obligations *issued* after December 31, 1954, so that the prior law would control any sale or redemption, even after 1954, of such obligations issued prior to 1955. While ten years have now elapsed since that date, we have no solid basis on which to dispute petitioners' claim that not only have numerous such transactions occurred in years which are still open but there may be some such obligations still outstanding (Pet. 5). And while the pending cases of which we are aware are relatively few in number,[6] they involve not insignificant sums

[6] In addition to the three cases now or about to be pending in this Court on petitions for certiorari (this case from the Second Circuit, *Midland-Ross* from the Sixth Circuit, and

of money (this case, for example, involves $369,329, plus interest).

Second, § 1232 applies only to obligations issued by a corporation or a governmental body, and not to obligations issued by individuals. While all of the litigated cases seem to have involved corporate obligations, the same question would be presented by notes issued by individuals.

Third, § 1232 does not itself answer the question whether an accrual-basis taxpayer must accrue "interest" in the form of original-issue discount in the same manner that stated interest must be accrued. Section 1232 was in effect a legislative overruling, at least for the future, of the Sixth Circuit's earlier decision in the *Caulkins* case, and, as often happens in such cases, it deals in terms not with the underlying principle but only with the particular manifestation, leaving the courts still to grapple with the "related" problems that might arise. Thus, § 1232 does not in terms say that the excess of the face amount of a note over the amount of money for which it was issued *is* interest and is to be accounted for in all respects in the same manner in which stated interest is accounted for. It is rather limited to the specific question involved in the *Caulkins* case and provides

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Real Estate Investment Trust from the First Circuit), and the cases of the other partners of petitioners which are pending in the Second Circuit and will, by stipulation, be controlled by the outcome of this case (*Koyle* v. *United States*, No. 28,862; *Hornstein* v. *United States*, No. 28,863; and *Erpf* v. *United States*, No. 28,895), we are aware of only the following three cases now pending: *Kehaya* v. *United States*, Ct. Cls. No. 27-61; *May* v. *Commissioner*, T.C. Docket No. 67,659; and *Meyer* v. *Commissioner*, T.C. Docket No. 1198-63.

simply that the "gain" on a "sale" (or a redemption treated as a sale) of a note, to the extent that it does not exceed the original-issue discount pro-rated over the period of holding, "shall be considered as gain from the sale or exchange of property which is not a capital asset" (*i.e.*, as ordinary income). Other questions which turn upon the characterization of original-issue discount as "interest" are thus not expressly answered by the statute (although its underlying purpose may, of course, provide a guide for their solution). And chief among those questions is the question directly in issue in this case—to wit, whether an accrual-basis taxpayer must accrue interest in the form of original-issue discount as well as interest which is labeled as such.

While § 1232 does significantly lessen the importance of the question for the future, the result of those limitations on its scope is that the question remains of at least as much continuing importance as many questions on which this Court is called upon to resolve a conflict. The subsequent statutory developments, therefore, do not provide a sufficient basis to oppose the petition in the face of the recently-affirmed conflict of decisions. We accordingly join with petitioners in urging that the Court grant certiorari on that question.

II

The second question presented by the petition is whether the Commissioner is estopped to challenge petitioners' treatment because he initially acquiesced in the decision in *Commissioner* v. *Caulkins, supra,*[7]

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[7] Rev. Rul. 11907, 1944 Cum. Bull. 5.

and did not withdraw the acquiescence until after the transactions involved in this case.[8] That question is insubstantial for two reasons: first, because, as shown in detail in the district court's opinion (Pet. 13a–18a), the *Caulkins* case was distinguishable on its facts and any reliance by petitioner upon the acquiescence in it was misplaced; and second, because in any event "the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law" (*Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 183; see also, *e.g., Manhattan Co.* v. *Commissioner,* 297 U.S. 129; § 7805 of the 1954 Code, *infra,* p. 19). Nor is there a conflict of decisions or any other reason for review of that question by this Court.

CONCLUSION

For the reasons stated, the petition for certiorari should be granted, but the grant should be limited to Question 1 as stated in the petition.

Respectfully submitted.

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[8] See Rev. Rul. 56–299, 1956–1 Cum. Bull. 603, superseding Rev. Rul. 55–136, 1955–1 Cum. Bull. 213.

APPENDIX

A. INTERNAL REVENUE CODE OF 1939 AND REGULATIONS 118.

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, * * * or gains or profits and income derived from any source whatever. * * *

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SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; * * *.

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(b) *Noninterest-bearing obligations issued at discount.*—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income

to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. * * *

(c) *Short-term obligations issued on discount basis.*—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(d) *Matured United States Savings Bonds.*—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than ten years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of this subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's net income is computed upon the basis of the accrual method of accounting or

for which an election made by the taxpayer under subsection (b) is applicable.

* * * * *

SEC. 48. DEFINITIONS.

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(c) *"Paid or incurred," "paid or accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer * * * but does not include—

* * * * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, * * *.

* * * * *

U.S. Treasury Regulations 118 (1939 Code):

§ 39.22(a)–17 *Sale and purchase by corporation of its bonds.* * * * (c) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

§ 39.42–7 *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 39.117(a)–1.

* * * * *

§ 39.117(a)–1 *Meaning of terms.*

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(d) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable

without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." * * * It is, therefore, not necessary for a taxyaper, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 39.42-7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken ito account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

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B. INTERNAL REVENUE CODE OF 1954.

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness,

which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

* * * * *

(2) *Sale or exchange.*—

(A) [As amended by Sec. 50(a), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

* * * * *

(ii) * * * an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

(b) *Definitions.*—

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. * * *

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SEC. 7805. RULES AND REGULATIONS.

* * * * *

(b) *Retroactivity of Regulations or Rulings.*—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

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U.S. GOVERNMENT PRINTING OFFICE: 1964